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CRITERIA FOR EXPANDING THE SALES TAX BASE: SERVICES AND EXEMPTIONS

Introduction

This Policy Brief focuses on issues associated with the sales tax base and discusses the criteria and factors that should be considered in deciding which services to add to the sales tax base and which sales tax exemptions to eliminate or add.

The Policy Brief is a modification of background material that was prepared for The Special Council on Tax Reform and Fairness for Georgians. The Tax Reform Council was established in 2010 (pursuant to HB 1405) to "conduct a thorough study of the state's current revenue structure" and make a report of its findings and recommendations no later than January 10, 2011.

Background

In nearly every state, the legislation that imposed state sales taxes stated that the sale or lease of goods (tangible personal property) would be taxed unless explicitly exempted, and that services would not be taxed unless explicitly enumerated.

When sales taxes were adopted there were very few exemptions provided and very few services included in the tax base. The goods that were commonly exempted were purchases by government, goods purchased for resale and, as an extension of that, goods that were transformed during the production process or were component parts of goods being produced. Not much else was exempted. And, since at that time services were a very small percentage of consumption and were considered harder to tax than goods, services were generally not included in the sales tax base. When Georgia adopted its sales tax in 1951 it followed this pattern.

Over the past several decades the base of the Georgia sales tax has decreased as a share of the state's economy (Figure 1). Sales tax base per $1000 of state personal income was $708 in 1980, but fell to $397 in 2009, a decrease of 44 percent. There are several reasons for this decline, but there are two in particular.

1. The Georgia sales tax applies mainly to the purchase and lease of tangible personal property, i.e., goods. Services are generally excluded. The Federation of Tax Administrators identified 166 services that at least one state taxed; Georgia taxes 36 of those. However, services have increased as a share of the economy, so a smaller share of consumption is being taxed under the sales tax, and is one of the reasons why the sales tax base has declined relative to the Georgia economy. Not taxing services means that the tax base is narrower, requiring a higher tax rate to obtain the same revenue.
2. There are over 110 exemptions from the Georgia sales tax. The number of exemptions granted has increased at an increasing rate over

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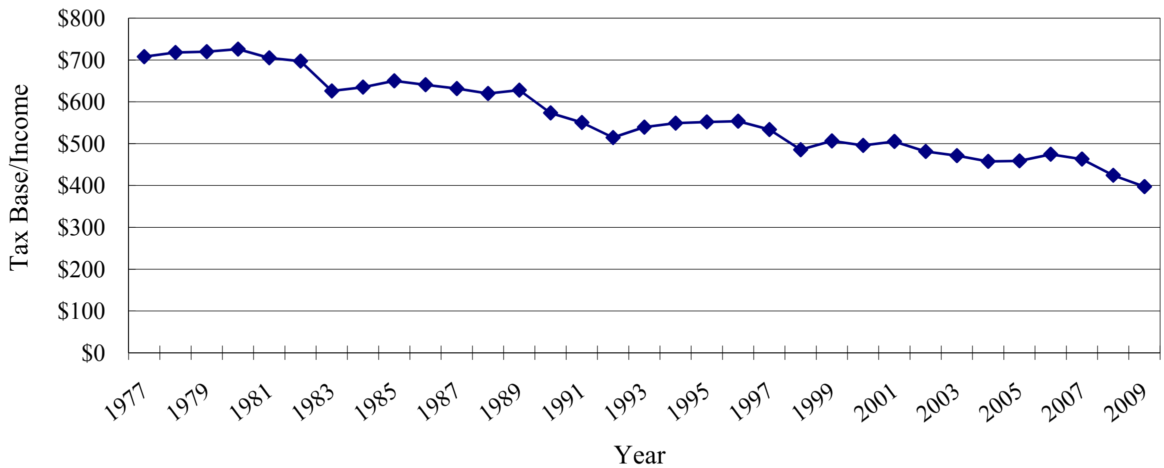
FIGURE 1. SALES TAX BASE PER $1000 OF PERSONAL INCOME



the past three decades, and is another reason for the decline in the sales tax base relative to the Georgia economy. The exemptions can be classified into those for purchases by government and governmental agencies, by agricultural businesses, by health providers and consumers of health products, by other industries and specific firms, by nonprofits, and by households.

Key Criteria

One of the principles for a good tax, and one of the Guiding Principles adopted by the Tax Reform Council, is to minimize economic inefficiency. This Principle, as stated by the Tax Reform Council, is: "Tax structures should minimize distortions of both household economic choices and of capital and labor allocations by business. This implies that tax structures and levels should minimize interference with private economic decisions and that marginal tax rates should be as low as possible." There are two general criteria that follow from this principle, tax only final consumption and tax all final consumption.

Tax Only Final Consumption

At the time that sales taxes were first adopted, exemptions were provided for goods that were purchased for direct resale or that were transformed in the production of a good. Imposing a sales tax on purchases of goods by retailers and then imposing the sales tax on the consumer for the same good would result in the tax being applied twice, i.e., tax pyramiding.

Sales taxes were designed to avoid such double taxation since the sales tax applied only on the final sale. But exempting just goods for resale and raw materials transformed in the production process meant that other purchases by businesses were subject to the sales tax; these purchases were considered final sales. Over time, arguments were made that other business purchases should be exempt, that is, should not be included in the concept of final sale. As a result, exemptions of machinery and equipment that came in direct contact with the materials being processed were adopted. Exemptions were also provided for things like packing materials, which had not been exempt because it was not a component part of the good. More recently, states have adopted the integrated plant theory, which argues that any machinery and equipment that is integral to the manufacturing process should be exempt.

Economists take an even broader view of what should be exempt. As they studied the sales tax, economists argued that taxing any input to the production process would result in tax pyramiding since the price of a good reflects the cost of all of the inputs to the production process, not just goods transformed in the production process. Economists make no distinction between raw materials, component parts and other purchases by business; all are considered inputs, and not a final sale. Thus, economists argue that only the final consumption should be taxed, and that business-to-business purchases should not be taxed. See McLure (2000) for a more extensive discussion of this argument. In general terms, final consumption is when the individual consumer buys a product (but see the more extensive discussion of final consumption below). So, in principle economists advocate not taxing business inputs, but taxing all final consumption, regardless of who makes that purchase.

The main reason for not taxing inputs is to avoid tax pyramiding. Tax pyramiding, i.e., levying the tax on each stage as the product goes through the production channels, increases the final effective tax. For example, if a 4 percent tax is levied on all $50 of inputs purchased by the manufacturer, then levied again on the $75 charged the retailer, and then again on the $100 paid by the final consumer, the total effective tax on the $100 purchase will be $9.00.

While the effective tax rate on the final purchase is 9 percent, and not the statutory rate of 4 percent, that is not the problem. Rather, the problem is that the effective tax rate on the final product will differ across products depending on the number of times the sales tax was applied in the production/distribution process and the share of the final cost attributed to each stage of production/distribution. These differences in the effective tax rates will distort consumption patterns, reducing purchases of goods with higher effective tax relative to goods with lower tax rates.

Although states have made efforts to avoid tax pyramiding, most states still rely substantially on sales tax revenues from items that are business inputs. One estimate indicates that nationally 40 percent of state retail sales tax revenues come from producer inputs (Ring 1999). This is too large a share for most states to easily replace.

However, in adding services to the sales tax base, care should be taken to avoid compounding the problems of the existing retail sales tax by avoiding taxing services purchased by businesses. Exempting businesses in general from paying sales tax on services would conform to the principle of not taxing business-to-business purchases. However, this approach is likely to be more difficult administratively than simply avoiding including those services that are mainly purchased by businesses. Thus, in selecting services to be added to the sales tax, the state should avoid adding to the sales tax base those services mainly or largely purchased by businesses.

Tax All Final Consumption

Economic efficiency implies that all final consumption should be taxed. This holds in principle regardless of whether the seller is a for-profit firm, a non-profit agency, or a government. The reasons for taxing all final consumption are twofold: 1. the desire is to keep the tax rate as low as possible for any given level of revenue, and; 2. to remove tax incentives to purchase one good or service rather than another.

Determining what constitutes final consumption is not straight forward. Individuals are not the only final user or consumer of goods and services. A "final consumer" also would include any individual or organization that produces something that is either not taxed or is not used in the production of something that is taxed. Consider a law firm that provides legal services to individuals but not to businesses. If the law firm's services are not taxed, its purchases of inputs would be considered final consumption. Likewise, there is no sales tax imposed on the "services" a religious organization provides to its members, so it is a final consumer of the goods and services it purchases. And, governments are final consumers if their services are not taxed. Based on the criteria that all final consumption should be taxed, the purchases of all of these organizations should be taxed.

While these two criteria are consistent with the desire to minimize economic distortions, they can conflict with other criteria. Thus, the desire to tax only final consumption and all final consumption has to be tempered by other considerations, which is the subject of the next section.

Other Considerations

The following are other factors that should be considered in applying the two criteria when deciding what to include in and what to exclude from the sales tax base. These factors are sometimes at odds with one another, and thus it is necessary to decide which factors should weigh more heavily in the decision of whether a particular purchase should be included in the sales tax base.

Be Fiscally Prudent

Georgia taxes many goods purchased by business, but it would be fiscally imprudent to expand sales tax exemptions in order to remove all of these business purchases from the sales tax at one time. This suggests that inputs not be immediately exempted unless there are good reasons to do so other than a concern about tax pyramiding.

Additionally, although there are many theoretical reasons to avoid taxing a particular business or product, policy-makers need to recognize most state sales taxes are a relatively minor influence over business or consumer decisions. Any exemption undermines the ability of the state to maintain a broad base and a low rate, which is often more important to economic development and fiscal health than any particular exemption.

Consider Competition for Economic Development

One factor to consider in deciding whether to exempt a business input is the extent to which not exempting the input would have a significant negative effect on business activity in Georgia. To the extent that other states provide exemptions for business-to-business purchases, Georgia may need to consider adopting the same exemptions in order to remain economically competitive.

This factor needs to be weighed in the context of the overall costs and benefits that the state provides. The pyramiding effect of the sales tax may be more than offset by other factors that lower the costs of doing business, such as low taxes overall, a good transportation network, or even considerations such as geographic proximity to a key market.

Consider Issues with Administration and Compliance

Business Response to a Tax: Consideration needs to be given to the likelihood that if the sales tax is imposed on a particular good or service that producers will leave the state, that the purchases will be made out-of-state or that the good or service would be moved to in-house production. For instance, services that can be provided electronically across state lines would be services that Georgia might avoid taxing. This would include preparation of wills, consulting reports, architectural drawings, manuscript editing, etc.

The sales tax is based on the destination principle, that is, the tax is levied where the good or service is used. The state does have a use tax that is imposed on out-of-state purchases of goods or services used in-state. So, a will drawn by an attorney in Florida for a resident of Georgia would be subject to the Georgia use tax if attorney services were added to the sales tax base. The problem, as with purchases from remote vendors such as Amazon.com, is the feasibility of collecting the tax. This is a compliance issue.

Because the state is currently unable to reasonably enforce the collection of the use tax on sales from remote vendors, the result is that consumers save money by purchasing goods and services over the internet. The effect of adding services that can be purchased over the internet to the sales tax would be to drive some of the purchases of services such as manuscript editing done out of state. Not only would there be a compliance issue in collecting a sales tax on manuscript editing done out of state, but it would also result in a loss of business for in-state editors.

Services for which the collection of the sales tax would be relatively easy and not likely to result in the migration of business to other states would include those that are tied directly to tangible personal property such as a car or house (repair and maintenance services) or to an individual (such as haircuts) and services that have an easily definable site where they are provided.

Another distortion that might occur is that a business will choose to bring a service in-house rather than contracting out in order to avoid a sales tax. For instance, if legal services are significant part of a business's costs, a sales tax on legal services may cause this business to hire in-house counsel instead of contracting with existing law firms.

Ease of Administration: Generally, states should not tax goods or services for which the cost of ensuring compliance is high relative to the revenue that would be generated. Babysitting services would be an example.

A tax on services will be easier to administer for both the state and the vendor if the services are provided by vendors who already have a sales tax certificate.

Administration is also simpler if there is a uniform tax base for the state and local sales taxes. This is also a requirement in the Streamlined Sales Tax Agreement. This suggests that the exemptions apply to all state and local sales taxes and that the goods and services that are taxed be the same in all taxing jurisdictions.

Treat Substitute Goods and/or Services the Same

If a good and service has close counterparts such that a consumer or business might easily substitute between the two, the goods and services should be taxed equivalently. Otherwise the tax system provides a competitive advantage to the non-taxed good or service. An example is the exemption for casual sales of used automobiles. Such sales compete with automobile dealers. The exemption provides an incentive for businesses to set up in such a way so as to avoid collecting sales taxes on the sale of an automobile.

Another example is the services provided by nonprofits that compete with for-profit organizations. Exempting the nonprofit sales from sales tax would give nonprofits a competitive advantage. For example, since Georgia taxes for-profit theater, it would be appropriate to tax tickets to non-profit shows. Similarly, nonprofit hospitals and for-profit hospitals should be treated the same.

This factor would also suggest that downloads of books, music, video games, etc. from the internet should be taxed since Georgia taxes the same things purchased as tangible personal property. Although there are still likely to be problems with compliance and administration, unlike services such as manuscript editing, taxing downloads of books, music, video games, etc., a tax on downloads is not likely to drive any business out of Georgia.

Finally, one often cited rationale for taxing services is that similar products are taxed differently depending on whether they are defined as a "good" or a "service." For instance, purchasing tax preparation software is taxed, but hiring an accountant to do your taxes is not.

Consider Equity

The sales tax is inherently regressive (meaning that sales taxes are a larger percent of income for lower income families than more affluent households). To reduce regressivity it is commonly argued that necessities, such as food, should not be taxed or should be taxed at a lower rate. However, in general, exempting certain goods and services is a very crude instrument for reducing the tax burden for low-income households. Wealthy families will normally benefit from the exemption much more than low-income families. (Food-for-home consumption is an example; the rich spend more on food than the poor, and thus benefit more than the poor from the exemption.)

An alternative to exempting a good or service is to provide a refundable tax credit for lower-income households and that phases out at higher income. Since very low income households do not pay income tax, the credit has to be refundable if it is to benefit such households. Such a credit could be designed to address specific purchases, for example food-for-home consumption, or to address the general regressivity of the sales tax.

It might also be possible to find a way to exempt certain purchases by lower income households. For example, the state exempts food purchased with food stamps and WIC coupons.

Assess Whether a Public Purpose is Served

A common justification for exempting certain goods or services or certain providers is that some important public purpose is served. The public purpose most commonly described is the provision of charity. But there are other public purposes that could be served by a tax exemption.

One public purpose is related to purchases that generate positive social benefits. Here, we mean that the good or service improves the lives of people beyond that of the direct consumer. For example, if a product reduces air pollution, everyone in the community benefits. However, the consumer is not likely to take those social benefits into account when making purchase decisions, and thus would buy less of this product than would be socially desirable. In such cases, exempting the product from the sales tax lowers the price and thus increases the consumption of the product to the more socially appropriate level.

Another public purpose is related to fraternal and civic organizations. These organizations provide a service to their members, suggesting that they be taxed under the sales tax. However, these organizations provide civic benefits well beyond the benefits to the individual so that the dues should be considered, in part, a contribution to promote civic engagement and good works. This implies that these organizations not be subject to sales tax on the services provided.

However, membership fees for county clubs, business clubs, gyms, etc., are fees for the privilege of using the club and its facilities. No one benefits from paying the membership fee other than the members. Thus, these organizations are likely candidates for being taxed.

Simply because an organization is serving a public purpose should not be sufficient to warrant an exemption. By granting an exemption, the state government is providing financial support. The state should provide the exemption only if the value the state receives from the services the nonprofit provides warrants the financial support provided.

Consider Tax Exemption versus Appropriation

Many sales tax exemptions are or have been provided essentially as a way for the state to contribute to the operation or construction of certain facilities. For example, the state has provided an exemption for the purchase of materials used in the construction of public venues such as the zoo, the Georgia Aquarium, and the Civil Rights Museum.

While a sales tax exemption may promote such a public purpose, a direct appropriation may be a preferred method for supporting the public purpose. The advantage of a direct appropriation is that it makes the level of the government's support more apparent. Furthermore, the financial support from a sales tax exemption depends on the amount of the organization's purchase of taxable items, which seems like an inappropriate basis for determining the state's support.

Considerations Associated with Specific Types of Organizations

There are certain categories of organizations and related goods and services that deserve special consideration. These include governments, health care providers, educational institutions, and nonprofit organizations. We discuss the issues associated with taxing the purchases of and sales by these entities.

- Government

The state does not have the legal authority to tax the purchases or sales of the Federal government. So, these are exempt from the sales tax. This includes the purchase of food using food stamps and WIC coupons.

In terms of the general fund services, if the state taxed its own purchases, its cost would go up by the same amount as the increase in revenue. Thus, other than a possible savings in administering the exemption, there does not seem to be much point in taxing government purchases.

For goods and services that a government provides, the government sets the price. It can raise that price directly or by adding a sales tax. In either case, the government captures the revenue. For example, consider the state lottery. In the purchase of a lottery ticket, the buyer 1) is purchasing a chance to win the lottery (the expected return on the gamble); and 2) is making a payment to the state (the difference between the price of the lottery ticket and the expected winnings). Since the expected winnings are less than the price of the lottery ticket, the payment to the state is essentially a tax on the lottery ticket already. If a sales tax was imposed on the lottery ticket, the state would have to reduce the share of the dollar that goes to the state in order to keep sales of lottery tickets constant. The net effect of taxing lottery tickets would be no change in revenue or in behavior.

If the state were to tax governments in general, the effect would be that state and local governments would be taxing one another. The state would tax local government purchases and sales, and local governments would tax state purchases and sales. The governmental sector as a whole would net to zero, but such a tax could create redistribution of revenue between the state and local governments. Specifically, local governments that provide higher and more costly levels of goods and services would contribute more sales tax to the state government, and the state government would most likely contribute significant sales tax revenues to local governments where there is a large state presence in their jurisdiction. From a policy perspective, this is likely not an appropriate way of redistributing resources between state and local government.

There are many services provided by public authorities, for example water and sewer authorities, hospital authorities, and transit authorities. (Sales to and by these entities are currently exempt from the sales tax.) These authorities are governmental organizations, and in that sense they should be treated like other governments. But they have some similarities with businesses, i.e., they sell goods and services, and in that sense they should be treated as a business. Most authorities are not funded by the sales tax (MARTA is an exception). Thus, taxing the purchases or sales of the authority would not generate revenue to the authority. Authorities sell their services and generally have to cover their cost through fees and other revenue, and many of the services provided by public authorities are ones that can, at least in theory, be provided by a regulated private sector entity (e.g., hospitals and transit). Thus, taxing public authorities may be more appropriate than taxing governments in general. Of course, it is possible that these authorities may be exempt for other reasons listed above, such as providing a charitable public purpose or providing a key business input.

- Healthcare

Healthcare is a service that in principle should be subject to the sales tax. Most healthcare services are not charity, so that is not a reason to exempt it. It may be that the public thinks that taxing healthcare is not appropriate or is unfair, which may be a principal reason why it is exempt in most states.

The fact that much of healthcare is paid through Medicaid and Medicare makes taxing it through the sales tax very difficult. This is true for both medical care and prescription medicines. With the adoption of Medicare Part D, taxing prescription medicines has become even more difficult; consequently only Illinois taxes prescriptions. When Georgia taxed prescriptions, it taxed only the out-of-pocket amount that the individual paid. Taxing the individual's out-of -pocket payment for prescription drugs raises questions of equity, since those individual's without insurance would have to pay the sales tax on the full cost, while others would pay only a tax on the co-pay.

Only four states tax healthcare purchases, but not directly through the sales tax. These states impose a net receipts tax on healthcare providers, where net receipts are gross receipts net of receipts from Medicaid and Medicare.

However, because the output of healthcare is not taxed, the tax pyramiding justification for exempting inputs is not relevant in the case of healthcare. Thus, exemptions of purchases by healthcare providers are possible candidates for elimination.

- Nonprofit

Charities are nonprofits, but charities are only a small fraction of all nonprofits. Charities are thought to serve some important public purpose, which provides a justification for exempting purchases by charitable nonprofits from the sales tax. However, exemptions for nonprofits should be granted only if they are truly providing a significant public benefit and then only if a direct appropriation would not be a more desirable means for accomplishing the objective of supporting the nonprofit.

It is hard to justify a blanket exemption for the purchases of non-charitable nonprofits. For example, a nonprofit that provides services to its members and not to a broader community probably does not qualify for an exemption based on a public purpose being served. As noted above, unless the value of what the nonprofit provides warrants the level of tax relief provided by an exemption, the nonprofit should not be given an exemption.

Goods and services sold by a nonprofit organization compete with those sold by for profit firms. This suggests that sales by nonprofits, whether charitable or not, should be taxed in order not to give nonprofits a competitive advantage. For example, Georgia taxes for-profit theater, so Georgia should tax tickets to performances produced by nonprofit groups. Nonprofit hospitals compete with for-profit hospitals, so there is reason to treat them the same.

- Education

Education is provided by government, nonprofits, and for-profit entities. Since public schools, including colleges, are governmental agencies, they should be treated the same way as governments in general are treated. If governments are exempt from the sales tax, then public education should be exempt.

However, some might argue that exempting just public education institutions and not other educational providers puts the other providers at a competitive disadvantage. That argument is not convincing for several reasons. Consider first a tax on purchases. The cost of the sales tax to public institutions is offset by the revenue the government receives from the sales tax. While the revenue may not go directly to the schools, the government's capacity to support schools is increased. Next, consider a tax on tuition. For schools from Pre-K to 12, no tuition is charged. So, not taxing public schools would have the same effect as imposing a tax on tuition, zero revenue would be raised in either case. For post-secondary schools imposing a tax on tuition would mean that students would pay tuition plus the sales tax. But a public post-secondary institution can lower its tuition to offset the sales tax, so that there would be no change in the total amount that students pay, and then the government could use the sales tax revenue to replace the lost tuition revenue.

Given that there are significant problems associated with taxing governmental schools, the next question is whether to exempt nonprofit educational providers but tax for-profit education providers. In this case, the concern for providing a competitive advantage is more relevant. It is probably appropriate to tax them the same.

The larger issue is whether education should be taxed at all. There is an argument that education provides substantial benefits to the public beyond the benefit to the individual student. The argument is that an educated citizenry is less likely to engage in crime, less likely to draw on public welfare programs, makes markets work more efficiently, etc. However, this argument probably applies only to Pre-K to12 education. Based on that argument, education, at least for pre-college education, should probably be exempt.

Post secondary education provides at least two services: it provides education to students and engages in research. The former includes general college courses as well as training in specific labor market skills. To the extent that only the students, and not the community at large, benefit from post-secondary education, there is not a public purpose justification for exempting post-secondary education.

Research is a more difficult matter. To the extent that new discoveries benefit society, then there is a public purpose argument for exempting at least this aspect of education. Thus, taxing tuition and not purchases by post-secondary institutions would perhaps be an appropriate policy. But, on the other hand, if tuition is not subject to sales taxes, then the purchases of post-secondary institutions could be taxed without concern for tax pyramiding. However, attempting to exempt purchases of goods and services that are used for research, perhaps because of a public good argument, but taxing other purchases by colleges, would seem to be administratively infeasible.

Even if tuition is not taxed, there are goods and services that education institutions at all levels sell besides the actual education. In fact, many of the current education exemptions are for sales of goods not directly related to classroom activities. If education should be exempt, that does not imply that all sales of education providers should be exempt.

Conclusion

This brief describes a series of common reasons for sales tax exemptions as well as some guidelines for deciding which services to tax when expanding the sales tax base. Two commonly cited principles when looking at the structure of the retail sales tax are: 1) the base should be as broad as possible, i.e., all consumption should be taxed, and 2) to the extent financially feasible, only final consumption should be taxed.

This second principle is intended to avoid tax pyramiding, a problem endemic to the retail sales tax. This problem underpins arguments for a broad based value added tax which typically taxes the net value of a good or service – the sales price of a product less the value of the inputs that went into production. However, almost all states have been reluctant to embark on this type of complete overhaul of their tax systems, and there are reasons that this sort of tax is difficult to administer at the state level. See Wheeler and Monkam (2007) for a discussion of these issues.

Given the current structure of most retail sales taxes, states then face a trade-off between sorting through a host of exemptions, which can alleviate tax pyramiding, and maintaining a broad tax base. Most states cannot afford to exempt all business inputs. Additionally, the broader the tax base, the lower the tax rate can be. Having a low tax rate generally helps alleviate the impact of tax pyramiding for all industries, while selected exemptions only help selected industries and potentially place an increased burden on everyone else.

The uneasy compromise implicit in most recommended retail sales tax reforms is that any new expansion of the sales tax base, particularly to services, should focus on final consumption. Meanwhile any exemptions from the existing "product based" sales tax base should be limited. This report generally reflects this compromise and suggests limiting exemptions to selected circumstances but expanding the sales tax only to services that represent final consumption.

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Effect of Change in Apportionment Formula on Georgia Corporate Tax Liability. This brief analyzes the effect of the change in the apportionment formula on firm's apportionment ration and tax liability. (December 2009)

An Analysis of the Relative Decline in Employment Income in Georgia. This report explores the declining rate of per capita income and employment income per job in Georgia. (December 2009)

Trends in the Level of Georgia's State and Local Taxes. This report explores long term trends in Georgia's state and local taxation including taxes as a percentage of personal income, reliance on taxes (as compared to fees, grants, etc) for revenue, and the changing balance between income taxes, sales taxes, and other taxes, and other trends. (December 2009)

Current Charges and Miscellaneous General Revenue: A Comparative. Analysis of Georgia and Selected States. This report examines Georgia's current charges and miscellaneous general revenue compared to the AAA bond rated states, the Southeastern neighbor states and the U.S. average for fiscal years 2007 and 1992. (December 2009)

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Georgia's Brain Gain. This brief investigates trends in the interstate migration of young college graduates. (March 2009)

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Buoyancy of Georgia's Sales and Use Tax. This brief explores the growth in sales tax revenue relative to the growth of the state's economy. (March 2009)

Buoyancy of Georgia's Personal Income Tax. This brief analyzes the growth in Georgia's Income Tax and explores reasons for trends over time. (March 2009)

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